Consumer Lenders Can Act Now To Reduce Post-Libor Risk

By **Lisa Fried and Allison Schoenthal** (July 25, 2019)

Lisa Fried

Allison Schoenthal

Following the announcement by the U.K.'s Financial Conduct Authority that it plans to stop requiring panel banks to contribute to the London Interbank Offered Rate by the end of 2021, financial regulators and industry leaders have been advising lenders and other industry participants to prepare for the cessation of Libor. This article addresses the litigation risk posed by Libor cessation specifically in the context of existing consumer loans, given the broad use of Libor in such loans. We will also address steps consumer lenders should be taking now to minimize their risk.

The Use Of Libor Is Widespread In The Consumer Market

Approximately $1 trillion worth of outstanding adjustable-rate mortgages — over 2.8 million separate loans — are based on interest rates calculated by reference to Libor. This represents over half of all flexible-rate mortgages in the U.S.[1] In addition, a significant number of student loans and reverse mortgages are linked to Libor.[2]

Consumer loans continue to be made with adjustable rates tied to Libor. For example, Fannie Mae and Freddie Mac's standard form of agreements for ARMs still refers to either Libor or a U.S. Treasury Index. Freddie Mac's standard language for an ARM linked to the six-month Libor rate states:

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the six month London Interbank Offered Rate ("Libor") which is the average of interbank offered rates for six-month U.S. dollar-denominated deposits in the London market, as published in The Wall Street Journal.[3]

Millions of existing and future loans are likely to be impacted by the cessation of Libor.

Improved Fallback Language on the Horizon, but Uncertainty Regarding Legacy Instruments

On July 12, the Consumer Products Working Group of the Federal Reserve-appointed Alternative Reference Rates Committee sought feedback on proposed improved fallback language specifically for new residential ARMs originated in advance of the anticipated cessation of Libor.[4] ARRC and other industry leaders have recommended replacing the Libor index with a new index based on the Secured Overnight Financing Rate in ARMs and other consumer agreements originated as the anticipated cessation of Libor approaches.

Significantly for the many holders of existing ARMs, though, industry leaders have not yet finalized guidance concerning how parties to such legacy instruments should continue to perform after Libor becomes less reflective of market conditions or ceases to exist at all. Most ARMs allow for the substitution of a new index based on comparable information if the original index is no longer available.[5] But such mortgages typically do not specify how to define an acceptable substitute or what it means for Libor to be unavailable.[6]

The Consumer Products Working Group has announced that it will turn its attention to the

transition for existing Libor ARMs later this year.[7] However, even if industry groups agree on a recommendation, precisely how the changes will be implemented remains to be seen, and even if banks use an industry recommended rate, based on SOFR, they are not immune from risk. (It would be challenging, to say the least, to amend mortgages made separately by millions of individual borrowers, a large proportion of which have been securitized and are now held in a diverse and in some cases difficult to track maze of investment vehicles.)

This uncertainty suggests a variety of claims that could arise in connection with legacy Libor-linked consumer loan documents:

Contractual Claims

Consumers and their counsel may attempt to state claims under theories that will be tied to the specific contract language at issue. The Financial Stability Board has examined this litigation risk and concluded that the most significant risk relates to frustration of purpose claims.[8] That doctrine excuses nonperformance where the value of the performance for one party has been destroyed.

Lenders should expect borrowers to assert this theory once Libor has been replaced, at least in those instances where the new rate (based on SOFR plus some margin or spread) is arguably higher than Libor would have been. Thus, lenders should strive to structure their Libor-replacement efforts to preserve the value of performance for both parties to reduce the risk of litigation.

Borrowers might also seek damages under theories of unjust enrichment or promissory estoppel, or for violation of the implied duty of good faith and fair dealing, arguing that any rate substitution effectively breaches their mortgage agreements. Whether and to what extent consumers succeed on such claims will depend on courts' interpretations of the underlying contractual language and how courts resolve questions such as when Libor truly is "unavailable" and whether the substituted rate is "reasonable" and/or "comparable".

If it can be persuasively demonstrated that the new rate is lower than what Libor would have been, leading to less costly mortgage loan payments, customers will be unable to show injury or harm, a required element of most contract-based claims.

Statutory Claims

Borrowers may also bring claims asserting violations of certain state unfair and deceptive practices acts and other laws, the punitive nature of which might come as a surprise to some observers. For example, Massachusetts's consumer protection law not only affords a private right of action to victims of unfair and deceptive trade practices,[9] but also permits courts to award double or treble damages and attorneys' fees in certain circumstances.

It likewise is conceivable that borrowers will assert claims under the Truth in Lending Act on a theory that interest rates had been changed without adequate notice. The possibility of such claims underscores the need for lenders and industry leaders to be clear and transparent about any changes relating to the replacement of Libor.

Tort Claims

As in most contested foreclosure actions, borrowers can also be expected to assert claims for negligence, fraud and fraudulent inducement in the face of any interest rate change. The majority of such claims are likely to be unmeritorious, because lenders typically owe no duty

to borrowers and because most lenders are clear and transparent in any representations they make about rate changes to borrowers. But we would expect many such claims to be asserted in any event.

Other Risks

We thus far have focused on the risk of litigation brought by consumers themselves, but it is important to note that litigation related to the cessation of Libor could also be brought by regulators and investors in instruments created through loan securitizations.

On the regulatory front, we note that enforcement agencies such as the Consumer Financial Protection Bureau and the Federal Trade Commission, both of which have authority to protect consumers from unfair and deceptive acts, may scrutinize the burden any transition away from Libor places on consumers as well as the transparency of communications with consumers about such a transition. State regulatory and enforcement bodies may also turn their attention to this issue. And with respect to investors, we would simply note that any interest rate change resulting in an overall reduction in the amounts borrowers had been paying under Libor necessarily would yield lower returns for investors, so it will be a challenge to please every stakeholder.

Act Now to Minimize Litigation Risk

Until a consensus is reached as to amending consumer loans pegged to Libor, the universe of claims a particular lender may face remains uncertain. Nevertheless, lenders can take action now to minimize their litigation risk by:

- Cataloging the Libor provisions in loan documents, documenting:
    - The dates on which each loan will terminate, flagging those that will extend beyond 2021;
    - Any “trigger” language that dictates when a fallback provision replaces a Libor benchmark;
    - Details about fallback provisions that describe how a consumer’s interest rate will be determined if Libor is not available;
    - Notice requirements related to the lender’s exercising authority under any fallback provision; and

    - Consent requirements to amend the contract in the event an amendment is needed.

- Determining whether the lender is currently offering any loans that are benchmarked to Libor;

    - Consider ceasing to offer loans in this form or at a minimum modifying these contracts to incorporate robust fallback language that provides flexibility to use an alternate benchmark if Libor is no longer available.

- Examining securitization contracts;

    - Consumer lenders that sell loans to investors should also catalog the fallback language contained in securitization agreements.

    - Such lenders should monitor and participate in the ARRC's work to develop fallback language for securitizations.

- Monitoring industry developments;

    - Establish a team tasked with remaining up to date on developments and best practices, e.g., the AARC's recent release of recommended fallback language for floating rate notes and syndicated loans[10] and anticipated future release of recommended fallback language for securitizations.[11]

- Scrutinizing proposed changes for a negative impact on consumers;

    - To minimize litigation and regulatory risk, lenders will want to take care that whatever changes they adopt do not disadvantage consumers. Rep. Brad Sherman, D-Calif., on the House Financial Services Committee, has indicated he will be watching to see how consumers are affected. He noted that if banks adopt a system that adds just 0.1% to the cost of a mortgage, it "would cost a

consumer hundreds of dollars in the first year ... and it would be very unfair.”[12]

  - Efforts to protect consumers must be balanced against obligations to shareholders. Of course, lenders’ interests are not served by increases in consumers’ interest rates that could increase default rates.

- Providing notice to consumers; and

  - Borrowers need to be educated about the end of Libor and the differences between Libor and alternative benchmarks.

  - Lenders should communicate changes to customers in ways that comply with notice requirements of their contracts as well as all banking, securities and consumer protection laws.

  - Lenders should set a timeline for identifying contracts that require amendments, securing required consent from consumers and any other named parties, and executing amendments.

- Tracking complaints and developing a dispute resolution process.

  - Lenders should implement an effective system to track complaints from consumers and investors about any changes to interest rates.

  - Lenders should also develop internal procedures for addressing consumer complaints that follow any contract modification.

Lisa J. Fried and Allison J. Schoenthal are partners at Hogan Lovells.

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[1] Edward Golding and Laurie Goodman, Libor's phaseout could make holders of reverse and adjustable-rate mortgages billion dollar winners, Urban Wire Housing and Housing Finance, The Urban Institute (Oct. 26, 2018), https://www.urban.org/urban-wire/Libors-phaseout-could-make-holders-reverse-and-adjustable-rate-mortgages-billion-dollar-winners. See also James McBride, Understanding the Libor Scandal, Council on Foreign Relations (Oct. 12, 2016), https://www.cfr.org/backgrounder/understanding-Libor-scandal.

[2] A 2014 study estimated that $80 billion in US student loans are linked to Libor. See Fin. Stability Bd, Market Participants Group on Reforming Interest Rate Benchmarks (March 2014) at 308, available at https://www.fsb.org/wp-content/uploads/r_140722b.pdf. The Urban Institute estimated that 60 percent, or $50 billion, of reverse home mortgages are linked to Libor. See Urban Institute, supra, note 1.

[3] https://sf.freddiemac.com/tools-learning/uniform-instruments/all-instruments#notes

[4] ARRC, Press Release, ARRC Releases Consultation on Fallback Contract Language for New Closed-End, Residential, Adjustable-Rate Mortgages for Public Feedback(July 12,2019),available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Consultation-Paper-Fallback-Language-Consumer-ARM-announcement.pdf.

[5] See Urban Institute, supra, note 1.

[6] Id.

[7] ARRC, ARRC Consultation Regarding More Robust Libor Fallback Contract Language for New Closed-End, Residential Adjustable-Rate Mortgages, (July 12, 2019), at 3, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf.

[8] Fin. Stability Bd., supra note 2 at 13.

[9] (M.G.L. c. 93A, § 9)

[10] ARRC, Press Release, ARRC Releases Recommended Fallback Language for Floating Rate NotesandSyndicatedLoans(April25,2019),available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Apr-25-2019-announcement.pdf.

[11] AARC, Press Release, ARRC Releases Consultations on Fallback Contract Language for Floating Rate Notes and Syndicated Business Loans for Public Feedback (September 24, 2018), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Sept-24-2018-announcement.pdf.

[12] Christina Rexrode, A Mortgage Mystery: What Happens to ARMs When Libor Goes Away?, Wall St. J. (Aug. 7, 2017), https://www.wsj.com/articles/a-mortgage-mystery-what-happens-to-arms-when-Libor-goes-away-1502098201.